Imperatives of Accounting Principles, Concepts and Conventions in the Preparation of Financial Statement

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Abstract

Accounting principles refer to rules of accounting that should be followed in preparation of all accounts and financial statements. The study takes an exploratory approach in an attempt to examine the Imperatives of Accounting Principles, Concepts and Conventions in the Preparation of Financial Statement. *These analysis are focused on an examination of how accounting concepts and convention help in the preparation of financial statement which are used in decision making and for evaluation of financial strength, profitability, and future protection of the organization. It can therefore be concluded that accountancy plays a vital role in the stewardship of an organization. Accounting has been defined as the process of recording, classifying, reporting and interpreting the financial data of an organization. While it is important for the accountant to have a sound knowledge of this phase of accounting process, it is often a relatively minor part of their total attention to the management reporting and interpretation of the meaningful implication of the data, thereby punctuating the importance of being fully abreast and utilizing to the fullest, all relevant accounting concepts and conventions. The study therefore recommended that since Accounting is therefore basically regarded as a language of communication in an organization like every system of communication; its main purpose must constantly be streamlined to give different types of information to interested persons. Because of this main purpose, accounting must continue to forms a major part of the total information system in any entity, be it business or non-business.*

Keywords: Accounting Principles, Concepts and Conventions, Financial Statement

INTRODUCTION

Accounting principles refer to rules of accounting that should be followed in preparation of all accounts and financial statements. Accounting Principles are a set of broad conventions that have been devised to provide a basic framework for financial reporting. As financial reporting involves significant professional judgments by accountants, these principles ensure that the users of financial information are not mislead by the adoption of accounting policies and practices that go against the spirit of the accountancy profession. Every business organization whether in the public or private sector is established to achieve certain objectives. This could be profit maximization as in the case of the private sector or efficient and timely provision of essential services at a reduced price, as in the case of the public sector. The performance of such business organization has to be reported in monetary terms to the owners of the business. (For example, shareholders in the case of private organization or the government as in the case of public). Accountancy plays a vital role in the stewardship of an organization. Accounting has been defined as the process of recording, classifying, reporting and interpreting the financial data of an organization. While it is important for the accountant to have a sound knowledge of this phase of accounting process, it is often a relatively minor part of his total attention to the management reporting and interpretation of the meaningful implication of the data. (Welgenbad & Dittrich, 1973).

Accounting is therefore basically regarded as a language of communication in an organization like every system of communication; its main purpose is to give different types of information to interested persons. Because of this main purpose, accounting forms a major part of the total information system in any entity, be it business or non-business (Inanga 1983). However, the following problems are encountered in the process of communicating this information.

i. As the information needs of these various groups do not tally, there are conflicts of interest among the various users of financial statements.
ii. The problem of subjectivity in preparing the financial statements. Thus, it becomes necessary that in preparing the financial statement, the accountant be guided by some basic assumptions, principles, concepts and conventions in other to ensure a high degree of standardization in financial reporting.
iii. Financial accounting involves the accumulation of historical records which is technically referred to as

stewardship accounting and these historical records form the embodiment of financial statement. Financial statements are the means of communicating to understand parties' information on the resources, obligations and performance of the reporting entity. (SAS2).

In preparation of these financial statements, certain assumptions, concepts, conventions and principles which provide the essential framework for expressing accounting information are used. These include;

i. The money measurement concept
ii. The going concern concept
iii. The business entity concept
iv. The realization concept
v. The dual aspect concept
vi. The accruals concept
vii. Prudence concept
viii. Consistency concept

These accounting concepts and conventions are seldom disclosed on the financial statement because they are generally accepted as being the undertaking of periodic preparation and presentation of financial statement; but, if in preparation and presentation of this financial statement, the fundamental concepts and conventions are not followed, problems will arise in analysis, interpreting and reporting financial statements. It is therefore essential for the understanding that the interpretation and meaningful analysis of financial statement that these basic concepts, assumptions, principles and conventions used in the preparation must be constantly borne in mind. Given the foregoing, the following problems are encountered in the process of communicating information; they will be problem of having more meaningful and reliable financial report; it will lead to misunderstanding of how transactions are accounted for' there will be problem of having useful information for making economic decision and; it can lead to conflict of interest among the various users of financial statements, if their information needs do not tally. The importance of accounting concepts and conventions in the preparation of financial statement could be seen in the assessment of financial viability of an organization. The accountant prepares the financial statement of most organization. Accounting concepts and conventions help the accountant in giving relevant financial report to the management of any organization as regards financial report to the management of any organization. In order to demonstrate the role of accounting concepts and convention producing a viable financial report of any going concern, the following objectives are set out in this study; to determine whether accounting concepts and conventions serve as a guide in the preparation of financial statement; to ascertain if accounting concepts and conventions assist the provision of useful information for making economic decision; to investigate whether accounting concepts and convention help in the understanding of how transactions are accounted for and to examine whether accounting concepts and conventions make financial reports more meaningful and reliable.

LITERATURE REVIEW

Accounting principles (Concepts or Conventions) refer to rules of accounting that should be followed in preparation of all accounts and financial statements. Accounting Principles are a set of broad conventions that have been devised to provide a basic framework for financial reporting. As financial reporting involves significant professional judgments by accountants, these principles ensure that the users of financial information are not mislead by the adoption of accounting policies and practices that go against the spirit of the accountancy profession.

Accounting Principles

Given that accounting principles are a set of broad conventions that have been devised to provide a basic framework for financial reporting, accountants must therefore actively consider whether the accounting treatments adopted are consistent with the principles. In order to ensure application of the accounting principles, major accounting standard-setting bodies have incorporated them into their reporting frameworks such as the IASB Framework.

The Accounting Equation and Double Entry Principle

The accounting equation refers to the fact that the assets of a business must be equal to the claims over the assets at any point in time. For a business organization which does not owe any liabilities to persons order than the owner has exclusive claim over the assets of the business. In this instance, the equation is:

Assets ¿capital

For a business that also owes liabilities to external parties, the claims over its assets consist of capital and liability, the equation is then expressed as:

Assets ¿ Capital+¿ Liabilities

Or

Assets −¿ Liabilities¿ *Capital*

Since assets minus liabilities equal net assets, the last equation can be expressed as:

Net assets ¿ *Capital*

Consequently, the double entry principle requires that the dual effect of every transaction should be recorded by posting a debit entry to one account and a corresponding credit entry to another account. This is why it is often said in accounting said that: *"for every debit entry, there is a corresponding credit entry and vice versa"*.

METHODOLOGY

The study takes an exploratory approach in an attempt to examine the Imperatives of Accounting Principles, Concepts and Conventions in the Preparation of Financial Statement. These analysis are focused on an examination of how accounting concepts and convention help in the preparation of financial statement which are used in decision making and for evaluation of financial strength, profitability, and future protection of the organization. However, it was not possible to cover all organization that use accounting concepts and convention in Nigeria. This is because much energy is required, it is expensive as well as time consuming.

RESULT AND DISCUSSION

Considering the exploratory nature of this paper, the basic discussions will revolve around the fundamentals of Accounting Concepts and Conventions as elaborately enumerated below.

Basic Accounting Concepts and Conventions

In order to maintain uniformity and consistency in preparing and maintaining books of accounts, certain concepts and conventions have been evolved and remained dominant overtime, from the list of principles enumerated above. These rules and principles are classified as concepts and conventions. These are foundations of preparing and maintaining accounting records. In every country (such as Nigeria), there are basic traffic rules to be followed by everyone that is driving a car on a major highway. Similarly, there are certain rules that an accountant should follow while recording business transactions and preparing financial statements. These may be termed as accounting concept, therefore accounting concept refers to the basic assumptions and rules and principles which work as the basis of recording of business transactions and preparing accounts. The main objective of the accounting concept is to maintain uniformity and consistency in accounting and financial statements. These concepts constitute the very basis of accounting. All the concepts have been developed over the years from experience and thus they are universally accepted rules. The following are the various accounting concepts that have become dominant in contemporary times; Business entity concept; Money measurement concept; Going concern concept; Periodicity Concept (Accounting period concept); Historical Cost Concept (Accounting cost concept); Duality concept (Double entry concept); Realization concept; Accrual concept and; Matching concept.

Business Entity Concept

This concept assumes that, for accounting purposes, the business enterprise and its owners are two separate independent entities. Thus, the business and personal transactions of its owner are separate. For example, when the owner invests money in the business, it is recorded as liability of the business to the owner. Similarly, when the owner takes away from the business cash or goods for their personal use, it is not treated as business expense. Thus, the accounting records are made in the books of accounts from the point of view of the business unit and not the person owning the business. This concept is the very basis of accounting. The business entity concept essentially posits that business and the owner are two separate or distinct persons. Accordingly, any expenses incurred by owners for themselves, or members of their family, drawn from the business will be considered as expenses and it will be shown as drawings. Thus every economic unit,

regardless of its legal form of existence is treated as a separate entity (in accounting) from parties having proprietary or economic interest in it. The following points highlight the significance of business entity concept:

- This concept helps in ascertaining the profit of the business as only the business expenses and revenues are recorded and all the private and personal expenses are ignored.
- This concept restraints accountant from recording of owner's private or personal transactions.
- It also facilitates the recording and reporting of business transactions from the business point of view.
- It is the very basis of accounting concepts, conventions and principles.
- Accounting records reflect the financial activities of a specific business or organization, not of its owners or employees;

Money Measurement Concept

This concept assumes that all business transactions must be in terms of money, which is in the currency of a country. In Nigeria for instance, all transactions are denominated or restated in terms of Naira (₦). The following points highlight the significance of money measurement concept:

- This concept guides accountants what to record and what not to record.
- It helps in recording business transactions uniformly.
- If all the business transactions are expressed in monetary terms, it will be easy to understand the accounts prepared by the business enterprise.
- It facilitates comparison of business performance of two different periods of the same firm or of the two different firms for the same period.
- The accounting process records only activities that can be expressed in monetary terms (with some exceptions).

Going Concern Concept

This concept states that a business firm will continue to carry on its activities for an indefinite period of time. Simply stated, it means that every business entity has continuity of life. Thus, it will not be dissolved in the near future. This is an important assumption of accounting, as it provides a basis for showing the value of assets in the statement of financial position (balance sheet). The following points highlight the significance of going concern concept:

- This concept facilitates preparation of financial statements.
- On the basis of this concept, depreciation is charged on the non-current asset (fixed asset).
- It is of great help to the investors, because, it assures them that they will continue to get income on their investments.
- In the absence of this concept, the cost of a fixed asset will be treated as an expense in the year of its purchase.
- A business is judged for its capacity to earn profits in future.
- The business entity for which accounts are being prepared is in good condition and will continue to be in business in the foreseeable future.
- The business unit will operate in perpetuity; that is, the business is not expected to be liquidated in the foreseeable future. A business is considered a going concern if it is capable of earning a reasonable net income and there is no intention or threat from any source to curtail significantly, its line of business.

Periodicity Concept (Accounting Period Concept)

All the transactions are recorded in the books of accounts on the assumption that profits on these transactions are to be ascertained for a specified period. This is known as accounting period concept. Thus, this concept requires that the statement of financial position (balance sheet) and comprehensive income statement (profit and loss account) should be prepared at regular intervals. This is necessary for different purposes like, calculation of profit, ascertaining financial position, tax computation etc. Furthermore, this concept assumes that, indefinite life of business is divided into parts. These parts are known as Accounting Period. It may be of one year, six months, three months, one month, etc. But usually one year is taken as one accounting period which may be a calendar year (12 month period) or a financial year. Accounting period concept suggests that, all the transactions are recorded in the books of accounts for a specified period of time. Hence, goods purchased and sold during the period, rent, salaries etc. paid for the period are accounted for and against that period only. Althoughthe results of a business unit cannot be determined with precision until its final liquidation, the

business community and users of financial statement require that the business be divided into accounting periods (usually one year) and that change in position may be measured over these periods. The following points highlight the significance of going concern concept:

- It helps in predicting the future prospects of the business.
- It helps in calculating tax on business income calculated for a particular time period.
- It also helps banks, financial institutions, creditors, etc., to assess and analyze the performance of business for a particular period.
- It also helps the business firms to distribute their income at regular intervals as dividends.
- Financial records pertaining only to a specific period are to be considered in preparing accounts for that period.

Historical Cost Concept (Accounting Cost Concept)

Historical or Accounting cost concept states that all assets are recorded in the books of accounts at their purchase price, which includes cost of acquisition, transportation and installation and not at its market price. It means that non-current or fixed assets like building, plant and machinery, furniture, etc., are recorded in the books of accounts at a price paid for them. Further, it may be clarified that cost means original or acquisition cost only for new assets and for the used ones, cost means original cost less depreciation. The effect of cost concept is that if the business entity does not pay anything for acquiring an asset this item would not appear in the books of accounts. Thus, goodwill appears in the accounts only if the entity has purchased this intangible asset for a price. Thus, this concept holds that cost is the appropriate basis for initial accounting recognition of all assets, acquisitions, services rendered or received , creditors and owners interest and it holds that subsequent to acquisition, cost values are retained throughout the accounting process. The following points highlight the significance of going concern concept:

- This concept requires asset to be shown at the price it has been acquired, which can be verified from the supporting documents.
- It helps in calculating depreciation on non-current assets (fixed assets).
- The effect of cost concept is that if the business entity does not pay anything for an asset, this item will not be shown in the books of accounts.
- Asset value recorded in the account books should be the actual cost paid, and not the asset's current market value

Duality concept (Double Entry Concept)

Dual aspect is the foundation or basic principle of accounting. It provides the very basis of recording business transactions in the books of accounts. This concept assumes that every transaction has a dual effect, which is it affects two accounts in their respective opposite sides. Therefore, the transaction should be recorded at two places. It means, both the aspects of the transaction must be recorded in the books of accounts. For example, goods purchased for cash has two aspects which are (i) Giving of cash (ii) Receiving of goods. These two aspects are to be recorded. Thus, the duality concept is commonly expressed in terms of fundamental accounting equation:

Assets = Liabilities + Capital

The above accounting equation states that the assets of a business are always equal to the claims of owners and the outsiders. This claim is also termed as capital or owners' equity and that of outsiders, as liabilities or creditors' equity. The knowledge of dual aspect helps in identifying the two aspects of a transaction which helps in applying the rules of recording the transactions in books of accounts. The implication of dual aspect concept is that every transaction has an equal impact on assets and liabilities in such a way that total assets are always equal to total liabilities. Once the two aspects of a transaction are known, it becomes easy to apply the rules of accounting and maintain the records in the books of accounts properly. The interpretation of the Dual aspect concept is that every transaction has an equal effect on assets and liabilities in such a way that total assets are always equal to total liabilities of the business. The following points highlight the significance of going concern concept:

- This concept helps accountant in detecting error.
- It encourages the accountant to post each entry in opposite sides of two affected accounts.
- Accounting equation implies total assets equal total liabilities plus owners' equity.

Realization Concept

This concept states that revenue from any business transaction should be included in the accounting records only when it is realized. The term realization means creation of legal right to receive money. Selling goods is realization, receiving order is not, implying that revenue is said to have been realized when cash has been received or right to receive cash on the sale of goods or services or both has been created. In other words, the realization occurs when the goods and services have been sold either for cash or on credit. It also refers to inflow of assets in the form of receivables. The major significance of this concept includes the following:

- It helps in making the accounting information more objective.
- It provides that the transactions should be recorded only when goods are delivered to the buyer.
- Any change in the market value of an asset or liability is not recognized as a profit or loss until the asset is sold or the liability is paid off.
- The concept establishes the rule for the periodic recognition of revenue as soon as (a) it is capable of objective measurement (b) the value of assets received is reasonably certain.

Accrual Concept

The meaning of accrual is something that becomes due especially an amount of money that is yet to be paid or received at the end of the accounting period. It means that revenues are recognized when they become receivable. Though cash is received or not received and the expenses are recognized when they become payable though cash is paid or not paid. Both transactions will be recorded in the accounting period to which they relate. Therefore, the accrual concept makes a distinction between the accrual receipt of cash and the right to receive cash as regards revenue and actual payment of cash and obligation to pay cash as regards expenses. The accrual concept under accounting assumes that revenue is realized at the time of sale of goods or services irrespective of the fact when the cash is received. The concept also requires that revenue is recognized when realized and expenses are recognized when they become due and payable without regard to the time of cash receipt or cash payment. The significance of this concept is highlighted below:

- It helps in knowing actual expenses and actual income during a particular time period.
- It helps in calculating the net profit of the business.
- Revenue and expenses are recorded when they occur and not when the cash is received or paid out.

Matching Concept

The matching concept states that the revenue and the expenses incurred to earn the revenues must belong to the same accounting period. So once the revenue is realized, the next step is to allocate it to the relevant accounting period. This can be done with the help of accrual concept. Therefore, the matching concept implies that all revenues earned during an accounting year, whether received or not received during that year and all cost incurred, whether paid or not paid during the year should be taken into account while ascertaining profit or loss for that year. The major significance underlying this principle includes:

- It guides how the expenses should be matched with revenue for determining exact profit or loss for a particular period.
- It is very helpful for the investors or shareholders to know the exact amount of profit or loss of the business.
- Transactions affecting both revenues and expenses should be recognized in the same accounting period.

CONCLUSION AND RECOMMENDATIONS

Every business organization whether in the public or private sector is established to achieve certain objectives. This could be profit maximization as in the case of the private sector or efficient and timely provision of essential services at a reduced price, as in the case of the public sector. The performance of such business organization has to be reported in monetary terms to the owners of the business. (For example, shareholders in the case of private organization or the government as in the case of public)**.** It can therefore be concluded that accountancy plays a vital role in the stewardship of an organization. Accounting has been defined as the process of recording, classifying, reporting and interpreting the financial data of an organization. While it is important for the accountant to have a sound knowledge of this phase of accounting process, it is often a relatively minor part of their total attention to the management reporting and interpretation of the meaningful implication of the data, thereby punctuating the importance of being fully abreast and utilizing to the fullest, all relevant

accounting concepts and conventions. From the foregoing therefore, it is recommended that since Accounting is therefore basically regarded as a language of communication in an organization like every system of communication; its main purpose must constantly be streamlined to give different types of information to interested persons. Because of this main purpose, accounting must continue to forms a major part of the total information system in any entity, be it business or non-business.

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